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Tobacco Price Support: An Overview of the Program[1]

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Summary

Over 93% of U.S. tobacco production is flue-cured and burley (both being cigarette tobacco types). These crops are particularly important to the agriculture of North Carolina (where flue-cured is grown) and Kentucky (where burley is grown). Together, these two states produce 65% of the total U.S. tobacco crop. The federal tobacco price support program is designed to support and stabilize prices for farmers. It operates through a combination of mandatory marketing quotas and nonrecourse loans. Marketing quotas limit the amount of tobacco each farmer can sell, which indirectly raises market prices. The loan program establishes guaranteed minimum prices. The law requires that the loan program operate at no net cost to the federal government. Apart from year-to-year budget impacts, no-net-cost provisions of the law are intended to assure that all loan principal plus interest will be recovered.

Industry Profile

World production of tobacco is estimated at about 17 billion pounds for 1997. Production data are collected for over 100 countries. However, nearly 70% of world tobacco is produced in the following eleven countries: China (7,690 mil. lbs.), United States (1,646 mil. lbs.), India (1,341 mil. lbs.), Brazil (1,225 mil. lbs.), Turkey (482 mil. lbs.), Zimbabwe (407 mil. lbs.).[2]

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[1]This is one of a series of CRS short reports on federal farm commodity price support programs. Data in this report, unless otherwise specified, are from recent issues of Tobacco Situation and Outlook Report, published by the Economic Research Service, U.S. Department of Agriculture.

[2] U.S. Department of Agriculture, Foreign Agriculture Service. Tobacco: World Markets and Trade. Washington, D.C. January 1998.

Some 124,000 U.S. farms harvested about 1,646 million pounds of tobacco on about 795,000 acres in 1997. The estimated farm value of the 1997 crop is $3.1 billion. Major U.S. tobaccos are flue-cured (produced primarily in North Carolina) and burley (produced primarily in Kentucky), which are both cigarette tobaccos. Other types of tobacco are used for cigars, chewing, and snuff.

Tobacco is grown in 16 states; North Carolina and Kentucky originate 65% of total production. Four other states (Tennessee, Virginia, South Carolina, and Georgia) produce another 26%. The high per acre value of tobacco sales (averaging nearly $3,900 in 1997) makes it critical to the income of the growers and important to the economies of the major producing states. For North Carolina in 1996, tobacco constituted 14% of the value of all farm commodities (crops and livestock); for Kentucky, tobacco accounted for 22% of the value of all commodities.

The United States is the world's largest exporter of manufactured tobacco products (cigarettes) and only slightly smaller than Brazil as a top exporter of unmanufactured tobacco leaf. During 1997, the United States exported 560 million pounds (farm sales weight) of leaf tobacco, valued at $1.54 billion. Major U.S. leaf markets were Japan, Germany, Belgium/Luxembourg, Netherlands, Turkey, and the United Kingdom. The value of U.S. manufactured tobacco product exports was $4.95 billion. The largest export cigarette destinations were Japan, Belgium-Luxembourg (much destined for re-export), Cyprus, Lebanon, the Russian Federation, and Saudi Arabia.

In 1997, U.S. manufacturers produced an estimated 720 billion cigarettes (about 30% were exported). American blend cigarettes are a combination of flue-cured, burley, and oriental tobaccos. All of the oriental tobacco is imported (from primarily Turkey). Beginning in 1994, cigarette manufacturers were required to use at least 75% U.S.-grown tobacco in cigarettes. Consequently, tobacco imports dropped substantially below recent levels. Legislation implementing new international trade rules (Uruguay Round Agreements Act, P.L. 103-465) has replaced the domestic content requirement with a tariff rate quota, which is not expected to be as effective at limiting tobacco imports.

Consumption of cigarettes has declined nearly 25% in the United States since 1981, from 640 billion to an estimated 480 billion in 1997. However, spending for tobacco products has increased as a result of price and tax increases. In 1997, consumers spent about $52 billion on tobacco products (94% for cigarettes).

Tobacco products are subject to federal excise taxes. In addition, all states and some local governments impose excise taxes. Nationally, in 1997, cigarette excise taxes averaged about 58 cents a pack, with 24 cents being federal. Excise tax collections during 1997 totaled an estimated $13.868 billion (federal, $5.942 billion; state, $7.750 billion; local, $176 million).

The Price Support Program

Small changes in the supply of tobacco can cause disproportionally large changes in wholesale prices (because consumption is relatively insensitive to price). Cyclical swings in tobacco prices, and the associated farm income crises, led to grower efforts to voluntarily control production in the early part of this century. In some cases, violence was used against uncooperative growers. But the nongovernmental efforts failed. During the Great Depression of the 1930s, the federal government adopted farm income and commodity price support policies that included mandatory supply controls for several major crops, including tobacco.

The tobacco price support program exists only for the economic benefit of farmers. It was created for the purpose of supporting the income and stabilizing the price of tobacco received by farmers. By law, the choice of whether or not federal support will be provided is determined by growers in a referendum held every three years.

When producers approve federal price support for tobacco, they become subject to marketing quotas. Marketing quotas are a supply control mechanism that indirectly increases market prices. At the same time, the federal government is required to guarantee prices at least as high as the level specified in the law.

Legislative Authority

The first commodity price support legislation was the Agricultural Adjustment Act of 1933. Various problems with this and subsequent legislation ultimately led to adoption of the Agricultural Adjustment Act of 1938 (P.L. 75-430). This permanent law established a supply control and price support program for tobacco that, even as amended, remains very much the same today. The current legal authority and requirements for the federal tobacco program are contained in 7 U.S.C. 1311-1316 and 7 U.S.C. 1445.

Administering Agency

Program administrative operations are carried out by the U.S. Department of Agriculture's (USDA) Farm Service Agency (FSA). Annual administrative costs are estimated at about $15 million in FY1998 for tobacco price support operations. This cost covers primarily salaries for some headquarters personnel and staff time devoted to the tobacco program in about 600 county offices. Price support operations (nonrecourse loans) are financed by USDA's Commodity Credit Corporation (CCC). The CCC obtains needed money by borrowing from the U.S. Treasury.

Program Operation

The federal tobacco price support program limits and stabilizes the quantity of tobacco produced and marketed by farmers. This is achieved through marketing quotas. In addition, minimum market prices are guaranteed to farmers through CCC nonrecourse loans.[3]

Marketing Quotas. When farmers vote in favor of price supports, they are at the same time agreeing to accept government restrictions on the amount of tobacco they can market. The national marketing quota is the amount judged sufficient to meet domestic and export demand, but at a price above the government support price. Each farm's quota

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[3] The term nonrecourse means that no additional recourse is taken against a borrower beyond taking ownership of the collateral. The collateral is accepted as full settlement of the debt.

is assigned to the land. So, the right to produce and market a specified quantity of tobacco resides with the owner of the land. A farmer can only begin to grow tobacco by purchasing or renting land that has a quota. By limiting the supply of tobacco, the market price is increased. Total farm revenue is raised because consumption does not decline enough to offset the price increase. In this way, farm income is supposed to be supported through artificially high market prices, rather than through direct government payments. This differs from other commodity support programs that utilize direct payments, rather than marketing quotas, as the principal subsidy mechanism.

Loans. Marketing quotas are not always totally effective at supporting market prices, given the numerous variables that affect tobacco supply and demand. Consequently, federal support prices are guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the USDA, using the formula specified in the law to calculate loan levels. The national loan price on 1998 crop flue-cured tobacco is $1.628 per pound; the burley loan price is $1.778.

At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. In such cases, the farmer is paid the loan price by a cooperative, with money borrowed from the CCC. The tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest.

No-Net-Cost and Marketing Assessments. Under the threat of legislative dissolution of the program by its opponents, Congress passed the No-Net-Cost Tobacco Program Act in 1982 (P.L. 97-218). This legislation imposes an assessment on every pound of tobacco marketed. The no-net-cost assessment on 1997 crop flue-cured is 1.628 cents per pound; the burley assessment is 1.778 cents per pound. Growers and buyers each pay a half of the no-net-cost assessment. Beginning in 1994, imported tobacco also became subject to the no-net-cost assessment. The assessment funds (which could amount to about $5 million in 1997) are deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations. Losses occur when a cooperative sells loan collateral tobacco at a price insufficient to cover the loan principal plus interest.

Tobacco, like other commodity price support programs, is subject to deficit reduction requirements enacted by the Omnibus Budget Reconciliation Acts of 1990 (P.L. 101-508) and 1993 (P.L. 103-66). A marketing assessment of 1% of the support price is collected on every pound of tobacco marketed. This assessment is equally divided also between producers and buyers. Importers began paying the full assessment in 1994. This deficit reduction assessment (with the revenue going toward deficit reduction and not the tobacco program) should generate about $30 million in FY1998.

Experience

Passage of the No-Net-Cost Tobacco Program Act made a significant change in federal price support policy. Shifting the financial burden for tobacco program losses from the federal government to growers encouraged a reduction in support prices (which was done by legislation in 1986). Initially, this stopped the decline in U.S. tobacco leaf exports. However, the growing competitiveness of foreign tobacco has continued to erode the U.S. share of export markets. Foreign tobacco had captured 45% of the domestic cigarette manufacturing market when Congress enacted a domestic content requirement. This domestic content requirement took effect in 1994 and limited foreign tobacco to 25% of the U.S. market. Under new international trading rules, the domestic content requirement is replaced with tariff rate quotas, which are less restrictive than previous domestic content requirements because duty drawback provisions allow the recovery of all duties paid on imported tobacco that is re-exported in cigarettes. In 1996, imported tobacco constituted 42% of U.S.-manufactured cigarettes.

The no-net-cost rule has muted much of the criticism that taxpayers are subsidizing tobacco farmers. The budgetary impact of the tobacco loan program is determined primarily by loan outlays (new loans made) and loan recoveries (repayment of old loans). In any given year, new loan outlays may be more or less than recoveries from the repayment of old loans. In FY1998, the expected net loan outlay of $317 million is the result of large new loans compared to a modest level of old loan repayments. Since tobacco is typically stored for extended periods, it can be several years before the loan inventory is sold. In all cases, the law requires that any losses of loan principal and interest be repaid from the no-net-cost account, which is funded from assessments on growers and buyers of leaf tobacco.

Table Tobacco Loan Program Outlays and Recoveries, FY1996-FY1999

Loan Program Operation	($ in millions)			
	FY1996 Actual	FY1997 Actual	FY1998 Estimate	FY1999 Estimate
Loan outlays(+)	27	162	549	286
Loan recoveries(-)	-495	-287	-232	-304
Net loan outlays(+) or recoveries(-)	-468	-125	317	-18
Deficit reduction marketing assessment receipts(-)	-28	-32	-30	-31
Total net budgetary expenditures(+) or receipts(-)	-496	-156	286	-49

Source: Data are compiled from U.S. Department of Agriculture, Commodity Credit Corporation. Commodity Estimates Book, FY 1999 President's Budget. Washington, DC February 2, 1998. p. 159.

There are other critics of the tobacco program. Free market advocates point to the competitive disadvantages caused by the program. Economists believe that without marketing quotas and price support loans, farmers would produce more tobacco, which would be sold at lower prices. The lower prices would lead to increased exports, and more domestic production would be used in U.S.-manufactured cigarettes—displacing some of the imported tobacco. Some health advocates say the federal government should not be supporting tobacco farm income and should get out of the tobacco business. However, elimination of the program would free producers from the production constraints of marketing quotas and result in more and lower-priced tobacco.

Elimination of the tobacco program would likely cause consolidation into fewer but larger, more mechanized tobacco farms, with reduced costs of production. Many of the smaller, higher cost farms would likely stop producing tobacco, but they would have very few alternative crops capable of such high per-acre revenues as tobacco. Economists predict that there would be a substantial adjustment cost from elimination of the program, and it would not fall solely upon those farmers, workers, and communities that would benefit from the free market efficiency gains.

Other USDA Tobacco-Related Activities

In addition to the tobacco price support program, the USDA administers several other programs designed to assist tobacco farmers, facilitate marketing, and provide information to federal program managers and policy makers. It administers subsidized multi-peril crop insurance for tobacco (as well as for other crops), which cost about $80 million in FY1996. Also, as with other crops, the Department collects, analyzes, and disseminates data on tobacco production, utilization, and prices, costing about $1.5 million in FY1997. Federal extension expenditures on education and pest management amounted to about $680 million in FY1997. The Department is specifically prohibited from spending research funds on the production, processing or marketing of tobacco, and from promoting the sale or export of tobacco or tobacco products. These prohibitions are contained in the annual appropriation law.

For More Information

- FSA each year issues an updated *FSA Commodity Fact Sheet* on the tobacco price support program (as well as other commodity programs), which includes eligibility information, program details, and historical data call FSA Legislative Liaison Staff at 202-720-3865 (or see the internet site http://www.fsa.usda.gov/pas/prgfact.htm).

- The *Tobacco Situation and Outlook Report*, published by USDA's Economic Research Service, is a periodic compendium of production, trade, demand, and other current and historical data, plus special analytical articles (call the Tobacco Situation Coordinator at 202-694-5820). The Economic Research Service has also published *Tobacco: Background for 1995 Farm Legislation* (April 1995), available from the ERS Information Center at 202-694-5050 (or see the internet site http://www.econ.ag.gov/Briefing/tobacco/).

- Additional information on tobacco and other USDA price support programs is available from the Food and Agriculture Section of CRS.